No. 2563

IN THE

# United States Circuit Court of Appeals

FOR THE

NINTH CIRCUIT

CLERE CLOTHING COMPANY, a corporation,

*Appellant,*

*vs.*

THE UNION TRUST & SAVINGS BANK, a corporation, Trustee in Bankruptcy of the Estate of PRAGER-SCHLESINGER COMPANY, a corporation, Bankrupt,

*Respondent.*



In the Matter of the Estate of Prager-Schlesinger Company, a Corporation, Bankrupt.

*Upon Appeal from the United States District Court for the Eastern District of Washington, Northern Division.*

## BRIEF OF RESPONDENT.

WAKEFIELD & WITHERSPOON

*Attorneys for Trustee.*

Spokane, Wash.

COLE PRINTING COMPANY

No.....

IN THE

# United States Circuit Court of Appeals

FOR THE

**NINTH CIRCUIT**

CLERE CLOTHING COMPANY, a corporation,

*Appellant,*

*vs.*

THE UNION TRUST & SAVINGS BANK, a corporation, Trustee in Bankruptcy of the Estate of PRAGER-SCHLESINGER COMPANY, a corporation, Bankrupt,

*Respondent.*

In the Matter of the Estate of Prager-Schlesinger Company, a Corporation, Bankrupt.

*Upon Appeal from the United States District Court for the Eastern District of Washington, Northern Division.*

## BRIEF OF RESPONDENT.

WAKEFIELD & WITHERSPOON

*Attorneys for Trustee.*

Spokane, Wash.

COLE PRINTING COMPANY

No.....

IN THE

# United States Circuit Court of Appeals

FOR THE

NINTH CIRCUIT

CLERE CLOTHING COMPANY, a corporation,

*Appellant,*

*vs.*

THE UNION TRUST & SAVINGS BANK, a corporation, Trustee in Bankruptcy of the Estate of PRAGER-SCHLESINGER COMPANY, a corporation, Bankrupt,

*Respondent.*

In the Matter of the Estate of Prager-Schlesinger Company, a Corporation, Bankrupt.

*Upon Appeal from the United States District Court for the Eastern District of Washington, Northern Division.*

## BRIEF OF RESPONDENT.

## ARGUMENT.

(References are to pages in the Transcript, unless otherwise indicated.)

The earliest important event in the career of the Prager-Schlesinger Company as far as this con-

troversy is concerned was the composition in May, 1912, which closed the first bankruptcy. The statement at page 2 of appellant's brief states acceptably to the trustee the situation as it was then: "The money to carry out the composition was advanced by this appellant, the Clere Clothing Company, one of Prager-Schlesinger Company's largest creditors at that time, and after the composition had been effected, the Prager-Schlesinger Company's assets were turned over to the Clere Clothing Company." There can be no dispute that after the composition the Clere Clothing Company had title to and possession of all the property and assets of the Prager-Schlesinger Company and was running a retail clothing business in Spokane under the Prager-Schlesinger Company's name. It is our contention that that state of facts never changed from that day until the final closing of the business and the adjudication in the present bankruptcy.

The appearance of the Gilmore Company in the early summer of 1912 is immaterial. They were only sales conductors in behalf of the Clere Clothing Company, as the record very clearly shows, and as was formally admitted by counsel (page 94, line 8).

If the Prager-Schlesinger Company ever became rehabilitated as an independent concern, the change occurred either at the time of the departure of the

Gilmore Company, or at the time of the alleged sale on January 25, 1913.

Consider, in the first place, what is shown by the books of the Prager-Schlesinger Company. Mr. Josiah Richards, whose qualifications as an expert accountant were admitted by appellant, testified that the books show no evidence of change in ownership of the business from the time the Clere Clothing Company took charge of it in June, 1912, until the last entry in the books in July, 1913: "I will say the books indicate that there was no change during the period from June 1st to the last entry in the books in July, 1913; that is, from June 1st, 1912, the accounts continue during the entire time. There are no closing entries. There was no inventory taken. There is no record of any bills payable in the books which would indicate a sale. Every account continues during this period without having been closed" (pages 90-91).

Similarly, the bank account remained the same. Mr. Child, Vice-President of the National Bank of Commerce, states (page 45) that at all times from the time the account was opened in 1912 until it was closed in 1913 it was always carried as the Clere Clothing Company account; that there was no change nor any direction to make a change; that it was operated under the bank's understanding with Mr. Smith, Secretary and attorney of the

Clere Clothing Company. The only reason the bank had, he says, for carrying the account in the name of the Clere Clothing was that they were "the only people we had any business with" (page 48).

There are certain minor practices connected with the bookkeeping and the financial operations which tend toward the same conclusion. For instance, it is Mr. Clere's testimony (page 134) that the Clere Clothing Company was in the habit of using the accommodation notes of the Prager-Schlesinger Company at a time when, according to his testimony, practically nothing was owed. More suggestive still is the fact that even after the purported sale of January 25, 1913, the Prager-Schlesinger Company was paying to the National Bank of Commerce interest upon notes owed there by the Clere Clothing Company and charging such payments to expense; the interest items were charged as an expense against the business, as stated by Mr. Richards (page 95), in exactly the same method as they would have been charged if the Clere Clothing Company were owning and operating the business. Mr. Child testified to the same effect: "Interest was paid by the business here in Spokane that was conducted under the name of the Prager-Schlesinger on these notes from time to time. Up to some time in June, 1913, in the spring, Clere quit paying and then

is when I called the loan. I think a great many of the principal payments were made on these notes through this Prager-Schlesinger business" (page 47). Even as late as June 27, 1913, the Secretary of the Clere Clothing Company wrote to Schlesinger complaining that that month's interest on the Clere Clothing Company's loan at the National Bank of Commerce had not been paid (Trustee's Exhibit 19).

Mr. Yeomans, Credit Manager for the Spokane Dry Goods Company, testified (page 56) that from May or June, 1912, until June or July, 1913, the Spokane Dry Goods Company continued to deliver goods at the Prager-Schlesinger Company store, handling the account at all times as the Clere Clothing Company account. At page 57 he testified that the Spokane Dry Goods Company had obtained judgment against the Clere Clothing Company in a suit upon this account. That case has since been appealed to the Supreme Court of the State of Washington and affirmed. A portion of the opinion of the Washington Court is hereinafter quoted, as an authority upon the question of law involved in this controversy.

More convincing to our mind, however, even than the fact that the books show no change in the ownership of the business, more convincing than the fact that the bank account remained throughout as

the Clere Clothing Company's account, or than any of the other circumstances shown by the record, is the fact that there was no separate capital put into the Prager-Schlesinger Company after the former bankruptcy. When the Clere Clothing Company, by Thomas H. Clere, acquired the certificates of stock of the Prager-Schlesinger Company those certificates represented an empty name. The Prager-Schlesinger Company had just gone through bankruptcy and had been divested of every dollar of its assets. The bankruptcy of the corporation had worked a practical dissolution. This fact more than anything else stamps the concern as a dummy corporation. Its business career was closed, like that of the Missouri Company described by the Court in Glidden & Joy Varnish Co. v. Interstate Nat. Bank (1895), 69 Fed. 912:

> "It is indisputable, from the evidence, that after the sale of its property to the Ohio company, and the cancellation of all its stock, except a nominal sum, 'to keep alive' its charter, the Missouri company did no business in Kansas City or elsewhere. It had no property, no capital, no credit, and no manager. The business at Kansas City, from and after the date of this transaction, was the business of the Ohio company, and was conducted by Dudley, as its manager. After that time, Dudley was the manager of the Ohio company. That company fixed and paid his salary as manager, and it was to that company that he made his reports and returns. After the sale of its property and the cancellation of its

stock, the Missouri company was nothing more than a dummy. It had probably a technical legal existence through the three shares of uncancelled stock held by the Ohio company, not as capital stock for any business purposes, but 'in trust to keep alive the charter' of the company. Its business career was closed. If not dead, it was in a comatose condition, closely bordering on death. It remained in this condition until 1893. In that year it was discovered that the Kansas City branch of the Ohio company, owing to the general depression in business then prevailing throughout the country, or to the mismanagement or dishonesty of Dudley, or from some other cause, was so much involved that its assets were probably insufficient to pay its debts. * * *

It cannot, when it is prosperous, claim the Kansas City business as its own, and, when it is unprofitable, claim that it is the business of the Missouri company. The law will not countenance any such thimblerigging. One corporation cannot avoid the payment of its just obligations by putting forward as the debtor another corporation, similar in name, which, if it has a legal existence at all, exists only in name, and as a mere dummy or scapegoat for the debtor corporation. * * *

Its liability is grounded on the fact that after the sale of its stock and property to the Ohio company the Missouri company went out of business, and that thereafter the Ohio company owned the property, and conducted the business through its manager, Dudley."

The claim of the Clere Clothing Company is founded upon the action taken at the meetings held in Belden & Losey's office on the evening of

January 25, 1913. The vital question in this controversy is whether or not at that time and place there was a fair and square sale of $30,640 worth of merchandise and fixtures by one *bona fide* corporation to another. Mr. Clere states: "At that meeting we had a discussion of the proposition and went over it" (pages 120-121). The minutes of the special meeting of the trustees of the Prager-Schlesinger Company (see Exhibit) show that the Board of Trustees, to-wit, T. H. Clere, L. A. Schlesinger and H. R. Newton, met at 7:30 p. m. on Saturday, January 25, 1913, and that Mr. Clere presented to the Board an offer to sell or dispose of the entire stock of furniture and fixtures belonging to the Clere Clothing Company, to the Prager-Schlesinger Company for the sum of $30,-640, and it is stated that the question was discussed and after a consideration, accepted. Ten minutes later, at 7:40 o'clock p. m., there was held a special meeting of the stockholders of the same corporation, the entire list of stockholders being represented, to-wit, T. H. Clere, L. A. Schlesinger and H. R. Newton, and by them the sale was ratified. That was not a transaction that can prevail against the rights of genuine creditors. It was not the case of one corporation offering to buy the stock of another and the other company accepting such offer and ratifying the acceptance by a stockholders' meeting; it was the case of Thomas H. Clere making the offer on behalf of the Clere Clothing

Company, and then convening as the Board of Trustees of the Prager-Schlesinger Company and proposing, considering, discussing and accepting the offer, and then convening as the stockholders of the Prager-Schlesinger Company and ratifying the transaction, all within the course of ten minutes. It was, as Mr. Clere said, "a case where a man could give anything he wanted for a stock of goods" (page 74).

Even after this transaction there was no visible change in the condition of the business. No bill of sale was taken. No entry of the transaction was made in the books. All accounts continued as before. The account at the bank was still the account of the Clere Clothing Company. Even the Clere Clothing Company continued to the last to ship goods from Syracuse to the Clere Clothing Company at Spokane (see middle of page 94). The testimony all shows that there was no change in the constitution or business dealings of the thing doing business as the Prager-Schlesinger Company from the time of the composition in 1912, when the stock was transferred to the Clere Clothing Company, until June, 1913, when the concern went into bankruptcy for the second time. The same Trustees (Schlesinger absent) threw the company into the second, voluntary bankruptcy (pages 69, 135).

In replying to appellant's argument let it be

observed at the beginning that the appellant is rather too greatly excited over certain language used by the District Judge in his memorandum of decision. This appeal, it should have been remembered by appellant, did not lie from the court's memorandum, but from the order shown at page 28, which recites:

> "And the court having heard the argument of counsel and examined the entire testimony and record in the case, and being of the opinion that the opinion of the referee contains a full and accurate review of the testimony; and that the conclusion of the referee that the bankrupt was a mere agent or instrumentality through which the claimant transacted its business in Spokane and that to allow said claims against the bankrupt would be a fraud upon creditors, is in accordance with the law and the evidence in this case, now, therefore, it is ordered, adjudged and decreed that the order of the referee denying said claims and expunging same from the list of claims filed herein be and it is hereby affirmed."

Furthermore, the expressions in the memorandum which shock the appellant are expressions made with respect to that branch of the case upon which the court did not rest its decision. As the court said, if he was correct in his conclusion as to the items included in the $30,640 it would only be ground for reducing the amount of the claim. The court, however, entirely rejects the claim and puts his decision upon the ground that the bank-

rupt was a mere agent or instrumentality of the claimant, or to put it exactly, that he was by no means satisfied that the referee erred in his conclusion to that effect. Appellant's objections, therefore, are directed against the memorandum rather than the judgment from which it appealed, and, besides, are directed against that branch of the case upon which the court found it unnecessary to express an opinion.

Hence the challenge by appellant that we name the suspicious items in the $30,640 note might well be disregarded. We are glad, however, to point out what they were—not simply for their value in showing that the note was without consideration to that extent, but because the very ability of the Clere Clothing Company to obtain a purported obligation of the Prager-Schlesinger Company which was half made up of debts which could not possibly be the debts of anybody except the Clere Clothing Company itself, shows that the Clere Clothing Company and the Prager-Schlesinger Company were the same; that there was nobody in the Prager-Schlesinger Company whose interests were adverse to the interests of the Clere Clothing Company; that whether the debts of the Clere Clothing Company or the debts of the Prager-Schlesinger Company were being paid was all one and the same to everybody concerned. The testimony of Mr. Clere, particularly at pages 130 and

131, and the testimony of Mr. Nuzum beginning at page 73, and Exhibits 17 and 18 in the handwriting of Mr. Schlesinger, the person who, as the claimant alleges, took the inventory, establish in our judgment that the note was not given for the actual value of the stock of merchandise, but was given for the amount which the Clere Clothing Company had "invested" in Spokane; "the amount," as Mr. Clere states at page 130, "that was due the Clere Clothing Company; the amount they had invested out there."

These exhibits show that the following items, approximately, were included in the $30,640 note:

(1) $4272.20 paid to the Exchange National Bank in addition to its dividend under the composition. Mr. Cohn's testimony at page 41 and the testimony of Mr. Coman beginning at page 58, show that the bank received an additional $4272.20. This was not due from the Prager-Schlesinger Company because the composition had discharged the Exchange National Bank's claim against it.

(2) $4736.02, the extra amount necessary to satisfy the claim of the Clere Clothing Company in the first bankruptcy in full (see testimony of Mr. Clere, pages 130-131). This amount was not owing by the Prager-Schlesinger Company for the same reason.

(3) Amounts of $500 to Levy of the Credit

Clearing House; $1890 to Thomas K. Smith and $450 to Danziger, the Clere Clothing Company's attorneys; and $800 to Thomas Clere, incidental expenses in connection with the composition of 1912, in all amounting to $3640. These amounts were payable by the Clere Clothing Company; not by the Prager-Schlesinger Company unless they were one and the same (see testimony of Mr. Nuzum at page 79; that of Mr. Clere at page 133).

(4) $3500, approximately, paid to the Clere Clothing Company by the dividend checks of other creditors. It would be inequitable to allow the Clere Clothing Company to receive the benefits of these checks because they were preferential payments made for the purpose of effecting the composition (see testimony of T. T. Grant beginning at page 52; that of Mr. Cohn at page 40; and that of Mr. Nuzum at page 76).

About the same result is reached in approaching the case from another point of view. The testimony of Mr. Richards shows that in June, 1912, the stock of merchandise was put upon the books at $40,000. It is evident from Mr. Clere's own statement at page 117 that the stock was overvalued $10,000; that its actual value was not over $30,000. The book value of the merchandise on January 25, 1913, the date of the sale, was $25,007, which amount represents a continuation of the original amount of $40,000, plus the additions to

the stock and less the depletions from sales. The true value of the merchandise on January 25, 1913, was therefore about $15,000 instead of $25,007 (see testimony of Mr. Richards at page 92).

If the evidence just reviewed is sufficient to justify the conclusions that the promissory note was made up of items aside from the purchase price of the stock of goods, it is very good evidence in support of all the other facts and circumstances which have led the Referee, the District Court and the Supreme Court of Washington, to decide that the Prager-Schlesinger Company had no separate existence.

It strikes us that appellant's counsel makes rather a damaging admission at the bottom of page 3 of his brief, in stating that the stock-certificates were taken over by the Clere Clothing Company for the purpose of "protecting itself on account of the money advanced to effect the composition." Had the composition been as faultless as the purported sale of 1913, the Clere Clothing Company would have advanced only what the stock was worth, and no further "protecting" would have been necessary. When, let us ask, did the Clere Clothing Company cease to be "protecting itself on account of the money advanced to effect the composition?" When did it decide to be contented with the value of the stock of goods?

Surely it is singular that the inventory claimed by the appellant to have been taken, and the memorandum from which the trustee claims the amount of the note was derived, foot up in exactly the same amounts. Mr. Belden recollects that the note was made up from a document before him showing a total of $30,640; it seems most reasonable to conclude that he was looking at the memorandum which was preserved and is before the court as an exhibit, rather than at the inventory which nobody has been able to find. Mr. Belden would charge the loss of the inventory to Mr. Nuzum, quoting Mr. Nuzum as stating that he "thinks he gave same to Schlesinger." In Mr. Nuzum's testimony at page 75 Mr. Nuzum doesn't "think"; he is quite positive: "I know Schlesinger took it."

We also disagree with appellant's characterization of the testimony of Mr. Clere as being direct and positive to the effect that the note was given for the purchase price of the stock. Appellant must refer only to Mr. Clere's direct testimony; not to his answers on cross-examination. As the referee observes at page 23: "Clere's testimony on this subject is damaging. While answering the leading questions of his attorney, Thomas K. Smith, he makes a good witness for the claimant. When cross-examined by Mr. Nuzum he was evasive, showing a surprising lack of memory of

things that a man in his position would naturally know something about and remember, especially things that would hurt his side of the case, and at least leads me to suspect that more than the stock and fixtures was taken into consideration in figuring the amount of the note." In his cross-examination Mr. Clere admits: "Yes, there was a memorandum used. We did have a memorandum which showed the figures which we claimed the Clere Clothing Company was out or had invested" (page 131).

Nor do we agree with the statement in appellant's brief at page 14 that in agreeing with the trustee's claims the court must conclude that the records of the Prager-Schlesinger Company were falsified. By the adoption of the resolution authorizing the execution of the note, the Prager-Schlesinger Company could pay $30,640, if it chose, for the stock; but if it paid more than the fair market value that fact would compel the *pro tanto* reduction of the vendor's claim in bankruptcy and is also, we believe, excellent evidence that the buying corporation was completely dominated by the other.

At page 15 of its brief appellant seeks to detract from the value of the testimony of Mr. Richards, expert accountant, by asserting that the books were very poorly kept. There is nothing in the record to indicate that the books were not well kept. But

assuming that they were not, that would be no answer to such facts as the following, which the books affirmatively show: That the Clere Clothing Company as late as February 4, 1913, was billing its shipments to the Clere Clothing Company at Spokane; that the business was paying interest upon the Clere Clothing Company's indebtedness to the bank and charging the payments to expense; that there were no closing entries either at the time the Gilmore Company withdrew or at the time the purported sale was made; and even a poor bookkeeper would make an entry of a purchase of $30,640 worth of merchandise or the giving of a $30,640 promissory note.

In discussing the law of the case counsel for appellant presents his argument as though there were no other significant circumstance than the manner in which the certificates of stock of the Prager-Schlesinger Company were held. "It is true," he states at the bottom of page 16 of appellant's brief, "that the Clere Clothing Company of Mr. Clere held all the capital stock of the Prager-Schlesinger Company to whom they had sold their stock of merchandise, but that of itself would not constitute a fraud," and again near the bottom of page 17 he asks, "Does the mere fact that Clere or the Clere Clothing Company held for their security or protection, the capital stock of this corporation, indicate or prove or establish in any way,

that the Prager-Schlesinger Company was the agent of the Clere Clothing Company?" The trouble with this analysis of the situation is that it takes into consideration only one of many facts. Consequently we have no quarrel with appellant's quotation from *In re* Hudson River Electric Power Company.

The case, also, of *In re* Watertown Paper Company is widely different from the case at issue. The stockholders were largely the same; the business of the Pulp Company was conducted from the office of the Paper Company, a certain portion of the office expense being charged to the Pulp Company; the two corporations were largely under the direction of the same officers; one company purchased practically the entire output of the other. But here the resemblance ends. The business of one company was not at the outset the business of the other. The business of the Prager-Schlesinger Company was at one time, just after the composition, the Clere Clothing Company's business, and it is impossible to discover when that fact was ever changed. The vital difference, however, between the two cases is this: The Pulp Company had valuable assets of its own represented by a paid-up capital stock held upon a dividend-getting basis. The Prager-Schlesinger Company on the other hand had been stripped of every dollar of its assets; it had no capital stock

and nothing except a name to save it from nonentity, and shares of stock whose only excuse for existence was to promote and foster the honesty of Louis Schlesinger. It is difficult to see what legal vestige remained of the Prager-Schlesinger Company after the bankruptcy in 1912. It is hard to conceive of a corporation without capital and without assets, and hard to believe that such a concern can, in modern times, exist even in contemplation of law.

The question is really a question of fact, not of law. The legal principle to be applied is acceptably stated in appellant's case, *In re* Watertown Paper Company, 169 Fed. 252, at page 256, which enumerates as follows the conditions under which courts will pierce the veil of corporate entity:

> "(1) The legal fiction of distinct corporate existence will be disregarded, when necessary to circumvent fraud. (2) It may also be disregarded in a case where a corporation is so organized and controlled, and its affairs are so conducted, as to make it merely an instrumentality or adjunct of another corporation."

That is undoubtedly the law, and we believe that the record brings this case within both of the above exceptions.

As we stated above, the Spokane Dry Goods Company, through the Spokane Merchants' Association, sued the Clere Clothing Company for a bal-

ance due upon goods delivered to the Prager-Schlesinger Company between August 1, 1912, and June, 1913, and recovered a judgment, which was affirmed in the Supreme Court April 5, 1915. Counsel for appellant will doubtless think himself imposed upon by our reference to an adjudication in another controversy which grows out of the same state of facts, but which is not a part of the record in this action. The opinion of the Washington court is certainly not binding as to the facts found; but it is surely a case in point for the consideration of the court along with the authorities cited in appellant's brief. We therefore quote from the opinion of the Supreme Court of Washington in the case of Spokane Merchants' Association, a corporation, v. Clere Clothing Company, a corporation (April 5, 1915), 42 Wash. Dec. (advance sheets) 353; 147 Pac. 414:

> "The evidence makes it too plain for argument that the delivery to Gilmore & Co. and the original delivery to the Prager-Schlesinger Co. were not consignments in the ordinary commercial sense of a transmission to an independent merchant or factor for sale on commission. They were mere deliveries to the appellant's agents to sell at retail and deposit the proceeds to the appellant's credit. The appellant financed the business in both instances and retained absolute control of the goods. The possession of the goods was at all times that of the appellant by its sales agent.
>
> The fact that the Prager-Schlesinger Co. was a corporation does not alter the case. The

re-organization of that company at the time of the original delivery to it of the goods was for the confessed purpose of giving the appellant an absolute control and oversight of its agent. This emphasizes the correctness of our conclusion. Clere at all times acted for and in behalf of the appellant. When he and appellant's attorney took over solely in consideration of the agency practically the entire capital stock of the Prager-Schlesinger Co., that company, by every just and reasonable intendment became a subsidiary corporation of the appellant. This status being once established, as it clearly was, if evidence short of an admission can establish anything, it was incumbent upon the appellant to show that the Prager-Schlesinger Co. was rehabilitated as an independent entity with complete control of its own functions and destiny at the time of the alleged sale of the goods to it on January 25, 1913. This the evidence wholly fails to establish. All of the capital stock of the corporation save one share was still in effect owned and in reality controlled by the appellant through its president and attorney, who still constituted two of the three trustees. The attorney was still retained as secretary. The appellant's bank account was still used *ad libitum* by the Prager-Schlesinger Co. True, the appellant's officers claim this was unauthorized and unknown to them, but it taxes credulity to assume it knew nothing of the state of its own bank account for months, especially since it had at the situs of the whole transaction its own attorney who was also trustee and secretary of the Prager-Schlesinger Co. confessedly so constituted for the appellant's protection. The very fact that no formal bill of sale was made and no chattel mortgage taken

> to secure the payment of the alleged purchase price of the goods, further lends strong color to the view that the Prager-Schlesinger Co. was still what it had been from the date of its re-organization, a subsidiary company of the appellant. Many other circumstances in evidence point to the same conclusion."

With reference to this case we might say, adopting the language with which appellant refers to the Watertown Paper case, "the facts therein and the holding of the court seem to be particularly pertinent to the case at bar."

The Trustee believes that to allow appellant's claim would be to permit the bankrupt to prove a claim against itself, and that the opinion of the referee and the judgment of the District Court should therefore be affirmed.

Respectfully submitted,

WAKEFIELD & WITHERSPOON

*Attorneys for Trustee.*